Report

of the

Examination of

Sugar Creek Mutual Insurance Company

Elkhorn, Wisconsin

As of December 31, 2003

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, *Governor*
Jorge Gomez, *Commissioner*

Wisconsin.gov

125 South Webster Street • P.O. Box 7873
Madison, Wisconsin 53707-7873
Phone: (608) 266-3585 • Fax: (608) 266-9935
E-Mail: information@oci.state.wi.us
Web Address: oci.wi.gov

August 16, 2004

Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
Madison, Wisconsin 53702

Commissioner:

In accordance with your instructions, an examination has been performed as of December 31, 2003, of the affairs and financial condition of:

SUGAR CREEK MUTUAL INSURANCE COMPANY
Elkhorn, Wisconsin

and the following report thereon is respectfully submitted:

I. INTRODUCTION

The previous examination of Sugar Creek Mutual Insurance (hereinafter also ”the company”), was done in 1999 as of December 31, 1998. The current examination covered the intervening time period ending December 31, 2003, and included a review of such subsequent transactions deemed essential to complete this examination.

The “Summary of Examination Results” contains elaboration on all areas of the company's operations. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The company was originally organized as a town mutual insurance company on February 1, 1873, under the provisions of the then existing Wisconsin Statutes. The original name of the company was The Farmers Mutual Fire Insurance Company of the Town of Sugar Creek. Subsequent amendments to the company's articles and bylaws changed the company's name to that presently used.

During the period under examination, there was one amendment to the articles of incorporation and no amendments to the bylaws. The amendment to the articles of incorporation was done to change the annual meeting time to 1:30 P.M.

The company is currently licensed to write property, including windstorm and hail, and nonproperty insurance. The company is currently licensed to write business in the following counties:

Dane	Kenosha	Walworth
Green	Racine	Waukesha
Jefferson	Rock	

A review was made of the policy and application forms currently used by the company. The company issues an approved policy with or without endorsements for terms of one year with premiums payable on the advance premium basis. The company also charges a policy fee of $5 for each installment.

Business of the company is acquired through 10 agents, three of whom are directors of the company. Agents are presently compensated for their services as follows:

Type of Policy	**Compensation**
Fire and Extended Coverage	13%
Homeowner's/Farmowner's/Commercial	13
Liability	13

The manager of the company adjusts most losses with the assistance of agents. An outside adjuster handles losses that require significant expertise due to magnitude or complexity. All loss payments are reviewed by the adjusting committee. Agents receive $10.00 for each loss reported, plus a travel allowance of $0.36 per mile, and a picture allowance of $1.50 for instant and $0.75 for digital.

Policyholders may participate in the management and control of the company by attending and voting at all annual or special meetings of the members. No member may vote by proxy. The annual meeting of the company for the election of directors and special meetings of the company are held in accordance with its articles of incorporation.

Board of Directors

The board of directors consists of nine members divided into three classes. One class is elected at each annual meeting for a term of three years. Vacancies on the board may be filled by the directors for the interim to the next annual meeting when a director shall be chosen for the unexpired term.

The current board of directors consists of the following policyholders of the company:

Name	Principal Occupation	Residence	Expiry
Robert Agnew	Director/Farmer	Whitewater, WI	2007
Earl Paddock	Retired Banker	Elkhorn, WI	2007
William R. Schaid *	Retired Insurance Agent	Walworth, WI	2007
Larry A. Bray *	Company Manager/Agent	Elkhorn, WI	2006
Martin Vanderstappen	Farmer	Lake Geneva, WI	2006
Bruce Vander Veen	Farmer	Sharon, WI	2006
George Lauderdale	Farmer/Company President	Elkhorn, WI	2005
Donald Schmaling	Farmer	Delavan, WI	2005
Neil N. Welch *	Insurance Agent	Janesville, WI	2005

* indicates the director is also an appointed agent for the company

Members of the board currently receive $100 for each meeting attended with the exception of the president and vice-president, who receive $200 and $125 per meeting, respectively. Directors also receive $0.36 per mile for travel allowances.

Officers

Officers are elected by the board of directors from among its members and hold office for one year or until their successors are duly elected and qualified. Officers serving at the present time are as follows:

Name	Office	Salary
George Lauderdale	President	$ 0
William R. Schaid	Vice President	0
Larry A. Bray	Secretary	69,000
Neil N. Welch	Treasurer	0

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The President, Secretary and Treasurer are members of all committees. The committees at the time of the examination are listed below:

Adjusting/Inspection Committee
George Lauderdale
Larry Bray
Neil Welch

Business Planning Committee
Earl Paddock
William R. Schaid
Bruce Vander Veen

Finance Committee
Robert Agnew
Larry Bray
Neil Welch

Personnel Committee
Earl Paddock
William R. Schaid
Martin Vanderstappen

Underwriting Committee
Robert Agnew
Donald Schmaling
Bruce Vander Veen

Growth of Company

The growth of the company since the previous examination as compiled from its filed annual statements was as follows:

Year	Net Premiums Earned	Policies In Force	Net Income	Admitted Assets	Policyholders' Surplus
2003	$769,304	1,669	$ 108,912	$3,995,179	$3,226,477
2002	733,257	1,694	181,606	3,899,625	3,066,610
2001	704,929	1,739	(182,689)	3,788,037	3,024,543
2000	611,507	1,754	47,968	3,917,670	3,205,140
1999	581,699	1,809	3,704	3,686,128	3,008,862
1998	592,007	1,874	(86,046)	3,699,921	3,038,046

The ratios of gross and net premiums written to surplus as regards policyholders since the previous examination were as follows:

Year	Gross Premiums Written	Net Premiums Written	Ending Surplus	Writings Ratios	
				Net	Gross
2003	$1,215,924	$768,380	$3,226,477	24%	38%
2002	1,222,681	783,261	3,066,610	26	40
2001	1,092,524	732,264	3,024,543	24	36
2000	1,089,280	632,568	3,205,140	20	34
1999	1,004,354	561,184	3,008,862	19	33
1998	1,024,857	601,160	3,038,046	20	34

For the same period, the company's operating ratios were as follows:

Year	Net Losses and LAE Incurred	Other Underwriting Expenses Incurred	Net Earned Premiums	Net Loss and LAE Ratio	U/W Expense Ratio	Com-posite Ratio
2003	$422,740	$378,878	$769,304	55%	49%	104%
2002	304,421	361,887	733,257	42	46	88
2001	707,432	352,739	704,929	100	48	149
2000	329,723	355,239	611,507	54	56	110
1999	408,212	334,187	581,699	70	60	130
1998	594,487	331,954	592,007	100	55	156

As indicated above, the company shows a decline in policyholders for the last six years, averaging around 2% decrease a year. The decrease to policies in force is attributable to the company's rate increases and a competitive market with larger companies offering homeowners and farmowners insurance. Though the number of policyholders has declined, the company continues to report strong surplus. The company's surplus has increased 7.2% from

1999 to 2003. During the period under examination, the company reported net income in four of the five years and increased surplus in those years. The results of the company's loss experience have been slightly above average compared to most town mutuals, with the exception in 2001. In 2001, the company reported five large fires and two storm catastrophes, which resulted for the first time in the company approaching the attachment point of its stop-loss reinsurance contract.

The company continues to work at tightening its underwriting procedures. Four of the five years reported underwriting losses. To address the underwriting losses, along with tightening its underwriting, the company has also decreased agent commissions, thus resulting in its underwriting expense ratio declining from 60% to 49% during the period under examination. The average expense ratio for town mutuals was about 43%.

II. REINSURANCE

The examiners' review of the company's reinsurance portfolio revealed that there is currently one ceding treaty. The treaty contained a proper insolvency clause and complied with s. Ins 13.09 (3), Wis. Adm. Code, concerning maximum wind loss. Company retentions of risk complied with s. Ins 13.06, Wis. Adm. Code.

Reinsurer:	Wisconsin Reinsurance Corporation
Effective date:	January 1, 2004
Termination provisions:	Either party may terminate the contract and/or any of the attached Exhibit(s) at any January 1, by giving the other party at least 90 days' advance written notice.

The coverages provided under this treaty are summarized as follows:

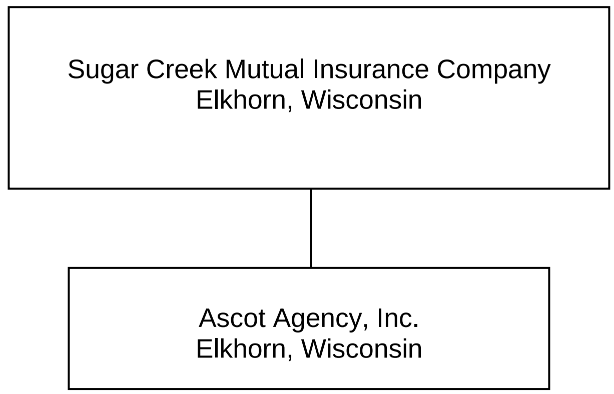
1.	Type of contract:	Class A Casualty Excess of Loss
	Lines reinsured:	All casualty or liability business
	Company's retention:	$5000 each and every loss occurrence
	Coverage:	100% of any loss, including loss adjustment expenses, above the company's retention in respect to each and every loss occurrence.
	Reinsurance premium:	50% of premium written
2.	Type of contract:	Class B First Surplus
	Lines reinsured:	All property business
	Company's retention:	$400,000 per ceded risk or at least 50% on a pro rata basis per ceded risk when the company's net retention is $400,000 or less in respect to a risk.
	Coverage:	Up to $800,000 on a pro rata basis when the company's net retention is $400,000 or more in respect to a risk. When the company's net retention is $400,000 or less in respect to a risk, the company may cede on a pro rata basis up to 50% of such risk.
	Deductible:	Annual aggregate deductible equal to 10% of loss and loss adjusting expense otherwise recoverable.
	Reinsurance premium:	The pro rata portion of all premiums, fees, and assessments charged by the company corresponding to the amount of each ceded risk.
	Ceding commission:	15% of premium paid and a profit commission of 15% of net profit, if any, accruing during each accounting period.

3.	Type of contract:	Class C-1 First Layer Excess of Loss
	Lines reinsured:	All property business
	Company's retention:	$40,000 per each and every loss resulting from one loss occurrence
	Coverage:	100% of any loss, including loss adjustment expenses, in excess of $40,000 in respect to each and every risk resulting form one loss occurrence; $60,000 limit of liability to each and every loss occurrence.
	Deductible:	Annual aggregate deductible of $40,000 (regardless of the number of claims involved)
	Reinsurance premium:	Based on the preceding four years' losses incurred by the reinsurer, subject to a minimum and maximum rate of 5.5% and 20% of the current net premiums written. The current rate is 9.11%; payable in deposit premium of $94,800 payable in monthly installments of $7,900 with the minimum premium for the current year of $76,000.
4.	Type of contract:	Class C-2 Second Layer Excess of Loss
	Lines reinsured:	All property business
	Company's retention:	$100,000 per each and every loss resulting from one loss occurrence
	Coverage:	100% of any loss, including loss adjustment expense, in excess of retention, subject to a limit of liability to the reinsurer of $300,000.
	Reinsurance premium:	5% of net premiums written; deposit premium of $51,900 payable in monthly installments of $4325 with a minimum premium of $42,000.
5.	Type of contract:	Class D/E Catastrophe Coverage & First Aggregate Stop Loss
	Lines reinsured:	All property business omnibus
	Company's retention:	<u>Part A – Castrophe Coverage</u> $90,000 of net losses (excluding LAE) arising out of each loss occurrence <u>Part B – Stop Loss Coverage</u> 75% of net written premium subject to a $685,000 minimum
	Coverage:	<u>Part A – Castrophe Coverage</u> 100% of the amount by which the loss exceeds the retention, limited to $250,000 per any one loss occurrence and $500,000 per year

	<u>Part B – Stop Loss Coverage</u> 100% of the amount by which the aggregate of the company's net losses (including LAE) exceeds the retention
Reinsurance premium:	The combined (Part A & B) rate for the second and all future annual periods shall be based on the preceding eight years' losses incurred by the reinsurer, subject to a minimum and maximum rate of 8% and 25% of the current net premiums written. The current annual rate is 8.0%. Deposit premium of $99,600 payable in monthly installments of $8,300; minimum premium of $80,000.

III. AFFILIATED COMPANIES

The company is a member of a holding company system. It is the ultimate parent. The organizational chart below depicts the relationship among an affiliate in the group. A brief description of the affiliate follows the organizational chart.



Ascot Agency, Inc. (the agency) was created by four directors of the company in 1989 for the purpose of providing complementary coverages not available through the company. In 1999, the agency was purchased by the company for a total of $1800 ($300 per share), with the company holding 100% of the outstanding shares.

The agency writes auto, crop, life and health insurance to policyholders and writes only non-competing business. As of December 31, 2003, the agency's unaudited financial statement reported assets of $1,068, liabilities of $0, and equity of $1,068. Operations for 2003 produced a net loss of $358. The company provides all of the administrative and management services necessary for the agency through a service agreement. In 2003, the agency paid the company $6,000 for services provided under this agreement.

IV. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2003, annual statement. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Policyholders' Surplus."

Sugar Creek Mutual Insurance Company
Statement of Assets and Liabilities
As of December 31, 2003

Assets	Ledger	Nonledger	Not Admitted	Net Admitted
Cash in company's office	$ 150	$	$	$ 150
Cash deposited in checking account	72,116			72,116
Cash deposited at interest	243,692			243,692
Bonds	1,708,401			1,708,401
Stocks and mutual fund investments	1,663,924			1,663,924
Mortgage loans on real estate				
Real estate	69,011			69,011
Premiums, agents' balances and installments:				
In course of collection	11,712			11,712
Deferred and not yet due	163,866			163,866
Investment income accrued		21,787		21,787
Reinsurance recoverable on paid losses and LAE	11,877			11,877
Electronic data processing equipment	10,667			10,667
Fire dues recoverable	132			132
Other expense related assets:				
Health Insurance Recoverable	3,022			3,022
Other nonexpense related assets:				
Cash Surrender Value of Life Insurance	14,822			14,822
Furniture and fixtures	3,859		3,859	
Other nonadmitted assets:				
Investment in Ascot Agency, Inc.	356		356	
Prepaid Expense	10,996		10,996	
Totals	$3,988,603	$21,787	$15,211	$3,995,179

Sugar Creek Mutual Insurance Company
Statement of Assets and Liabilities (cont.)
As of December 31, 2003

Liabilities and Surplus

Net unpaid losses	$ 136,145
Unpaid loss adjustment expenses	2,000
Commissions payable	42,736
Unearned premiums	526,900
Reinsurance payable	7,553
Amounts withheld for the account of others	3,352
Payroll taxes payable (employer's portion)	882
Other liabilities:	
Expense related:	
Accounts payable	2,404
Directors' and Agents' Fees and Expenses Payable	2,861
Accrued Deferred Compensation	15,813
Nonexpense related:	
Premiums received in advance	28,056
Total Liabilities	768,702
Policyholders' surplus	3,226,477
Total Liabilities and Surplus	$3,995,179

Sugar Creek Mutual Insurance Company
Statement of Operations
For the Year 2003

Net premiums and assessments earned		$769,304
Deduct:		
Net losses incurred	$384,373	
Net loss adjustment expenses incurred	38,367	
Other underwriting expenses incurred	378,878	
Total losses and expenses incurred		801,618
Net underwriting gain (loss)		(32,314)
Net investment income:		
Net investment income earned	77,811	
Net realized capital gains	58,590	
Total investment gain (loss)		136,401
Other income:		
Miscellaneous Income	4,825	
Total other income		4,825
Net Income (Loss)		$108,912

Sugar Creek Mutual Insurance Company
Reconciliation and Analysis of Surplus as Regards Policyholders
For the Five-Year Period Ending December 31, 2003

The following schedule is a reconciliation of surplus as regards policyholders during the period under examination as reported by the company in its filed annual statements

	2003	**2002**	**2001**	**2000**	**1999**
Surplus, beginning of year	$3,066,610	$3,024,541	$3,205,139	$3,008,862	$3,038,047
Net income	108,912	181,606	(182,689)	47,967	3,699
Net unrealized capital gains or (losses)	52,648	(142,671)	1,338	143,165	(26,246)
Change in non-admitted assets	(1,693)	3,134	753	5,145	(6,638)
Surplus, end of year	$3,226,477	$3,066,610	$3,024,541	$3,205,139	$3,008,862

Reconciliation of Policyholders' Surplus

A reconciliation of the policyholders' surplus as reported by the company in its filed annual statement and as determined by the examination is detailed in the following schedule:

Policyholders' surplus per December 31, 2003, annual statement		$3,226,477
Item	**Increase**	
Unearned Premium	$28,406	
Reserve Development	48,208	
Increase to Surplus per Examination		76,614
Policyholders' Surplus per Examination		$3,303,091

Examination Reclassifications

	Debit	Credit
Reinsurance Payable	$4,261	$
Commission Payable		4,261
Total Reclassifications	$4,261	$4,261

V. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

Comments and recommendations contained in the last examination report and the action taken on them by the company are as follows:

1. Corporate Records—It is recommended that the minutes clearly indicate board approval of all investment transactions, pursuant to s. Ins 6.20 (6) (h), Wis. Adm. Code.

   Action—Compliance.

2. Corporate Records—It is also recommended that committee reports and recommendations that are being reviewed and/or approved be maintained with the board of directors' minutes, pursuant to s. Ins 6.80 (4), Wis. Adm. Code.

   Action—Compliance.

3. Corporate Records—It is recommended that directors with conflict of interest properly abstain from voting on matters affecting their interest and that the minutes clearly indicate it, pursuant to s. 612.18, Wis. Stat.

   Action—Compliance.

4. Related Party Transactions—It is recommended that the company execute a new administrative agreement with the Ascot Agency and that the new agreement be reported to the Commissioner immediately after approval, pursuant to s. 612. 18, Wis. Stat.

   Action—Compliance.

5. Related Party Transactions—It is recommended that the company file the purchase agreement for approval prior to completing the purchase of the ascot Agency, pursuant to s. Ins 6.20 (6) (d) 4, Wis. Adm. Code.

   Action—Compliance.

6. Fidelity Bond and Other Insurance—It is recommended that the final salary continuation agreement be drafted and signed by the appropriate personnel.

   Action—Compliance.

7. Disaster Recovery Plan—It is recommended that the company establish a written disaster recovery plan.

   Action—Compliance.

8. Business Plan—It is recommended that the company establish a business plan that will more specifically address the issues of premium growth and expenses.

   Action—Compliance.

9. Net Unpaid Losses—It is recommended that the company adopt procedures for timely settlement of claims, in compliance with s. Ins 6.11 (3) (a) (2), Wis. Adm. Code.

   Action—Compliance.

Current Examination Results

Corporate Records

The minutes of the annual meetings of policyholders and meetings of the board of directors and committees thereof, were reviewed for the period under examination and also for the subsequent period.

Biographical data relating to company officers and directors have been reported in accordance with the provisions of s. Ins 6.52, Wis. Adm. Code.

The company has executed formal written agreements with its agents. The contracts do not include language indicating the agent will represent the company's interests "in good faith." It is recommended that the company execute formal written agreements with its agents that include language indicating that the agent will represent the company's interests "in good faith."

Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors of any material interest or affiliation on the part of its officers, directors, or key employees which conflicts or is likely to conflict with the official duties of such person. A part of this procedure is the annual completion of a conflict of interest questionnaire by the appropriate persons. The company has adopted such a procedure for disclosing potential conflicts of interest. Conflict of interest questionnaires were reviewed for the period under examination. Directors who owned the Ascot Agency prior to 1999 properly disclosed that potential conflict; since the date that the company purchased Ascot no conflicts have been disclosed.

Fidelity Bond and Other Insurance

The company is afforded coverage under the terms of the following bonds or contracts and has complied with s. Ins 13.05 (6), Wis. Adm. Code, which sets forth the minimum requirements for fidelity bond coverage:

Type of Coverage	Coverage Limits
Fidelity bond	$250,000
Directors' and Officers' Liability	$5,000,000 each and in the aggregate Deductible: $5,000
Errors and Omissions	$1,000,000 each and in the aggregate Deductible: $1,500
Workers Compensation:	Statutory
By accident	$100,000 each accident
By Disease	$100,000 policy limit
By Disease	$500,000 each employee
Errors and Omissions	
Agents	$1,000,000 each claim and in the aggregate Deductible: $1,500 each
Commercial Package	
Building	$145,700
Personal Property	$25,000
General Liability	$1,000,000
General Liability - Medical	$5,000
Inland Marine (Equipment Floater)	$10,000 accounts receivable $27,000 hardware
Key Employee Life Insurance (2 employees)	$242,000

Underwriting

The company has a written underwriting guide. The guide covers all the lines of business that the company is presently writing.

The company has a formal inspection procedure for both new and renewal business. A sampling of new applications and renewal business is inspected by committee members who are independent of the risk under consideration and review.

Claims Adjusting

The company has an adjusting committee consisting of at least three directors as required by s. 612.13 (4), Wis. Stat. The function of this committee is to adjust or supervise the adjustment of losses.

Accounts and Records

The examiners' review of the company's records indicated that the company is in compliance with s. Ins 13.05, Wis. Adm. Code, which sets forth the minimum standards for the handling of cash and recording of cash transactions by town mutual insurance companies. The examiners noted the following:

1. A proper policy register is maintained
2. A proper cash receipts journal is maintained
3. A proper cash disbursements journal is maintained
4. A proper general journal is maintained
5. A proper general ledger is maintained

An extensive review was made of income and disbursement items. Cash receipts were traced from source records and the proper recording and eventual deposit thereof ascertained. Negotiated checks issued during the period under examination were reviewed, test checked for proper endorsement and traced to cash records. The verification of assets and determination of liabilities were made as of December 31, 2003. The company is audited annually by an outside public accounting firm.

In November 2003, the company implemented new insurance accounting software. During the examination, the company was still working to resolve problems incurred from the conversion. During the review of the company's numerous system generated reports, the examiners noted many discrepancies in its premium reports; however, the examiners believe that the reports were materially accurate. The company was able to provide reconciliations of these reports to the balances on the annual statement. It is suggested that the company work with its software vendor to fix the problems noted with the accounting system so that premium balances are reported accurately. Refer to the "Advance Premium" and "Unearned Premium" sections of the report for further details.

EDP Environment

Company personnel were interviewed with respect to the company's electronic data processing environment. Access to the computers is limited to people authorized to use the computers.

Company personnel back up the computers daily by burning critical data onto a CD and backing-up the complete system onto a tape. The current CD and tape are always kept offsite and are copied over after two weeks. Company personnel also archive data to CDs weekly. These CDs are kept permanently. Back-up copies of the year-end data are kept indefinitely in a fire proof vault.

A manual which describes how to use the company's software and outlines the steps to complete specific tasks assists in the continuity of operations for seldom-used applications, training, or when staff turnover occurs. The company has manuals documenting the use of its software.

Business Continuity Plan

A business continuity plan identifies steps to be performed by a company in the event of business interruptions including, but not limited to the inability to access its computer, the loss of information on its computer, the loss of a key employee, or the destruction of its office building. The company has developed a business continuity plan. The company's business continuity plan appears to be adequate.

Invested Assets

Section 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

(1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and

(2) Any insurer may acquire and hold securities in bearer form.

For securities not held under a custodial agreement or trust arrangement with a bank or banking and trust company, s. Ins 13.05 (4), Wis. Adm. Code, requires that:

> Non-negotiable evidences of company investments such as registered bonds, certificates of deposits, notes, etc., shall be maintained in a safe or vault with adequate safety controls or in a safety deposit box in a bank. Negotiable evidences of company investments shall be maintained in a safety deposit box in a bank. Access to a company safety deposit box containing negotiable securities shall require the presence and signature of at least 2 officers, directors or employees of the company.

The company is in compliance with these requirements.

Investment Rule Compliance

The investment rule for town mutual insurers allows a company to invest in common stocks, common stock mutual funds, and other higher risk investments (referred to as “Type 2”) provided that the town mutual has a sufficient amount of lower risk investments (referred to as “Type 1”). A town mutual may invest in Type 2 securities only if it already has sufficient Type 1 investments. Type 1 investments must equal or exceed the greater of items 1, 2, or 3.

1.	Liabilities plus $300,000	$1,068,702
2.	Liabilities plus 33% of gross premiums written	1,169,957
3.	Liabilities plus 50% of net premiums written	1,152,892
4.	Amount required (greater of 1, 2, or 3)	1,169,957
5.	Amount of Type 1 investments as of 12/31/2003	2,423,727
6.	Excess or (deficiency)	$1,253,770

The company has sufficient Type 1 investments.

ASSETS

Cash and Invested Cash **$315,958**

The above asset is comprised of the following types of cash items:

Cash in company's office	$ 150
Cash deposited in banks-checking accounts	72,116
Cash deposited in banks at interest	243,692
Total	$315,958

Cash in company's office at year-end represents the company's petty cash fund. A physical count was made by the examiners during the course of the examination and the balance reconciled to year-end.

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained in a bank. Verification of the checking account balance was made by obtaining confirmation directly from the depository and reconciling the amount shown thereon to company records.

Cash deposited in banks represents the aggregate of six deposits in six depositories. Deposits were verified by direct correspondence with the respective depositories and by an actual count and inspection of certificates and/or passbooks. Interest received during the year 2003 totaled $8,201 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 2.96% to 3.89%. Accrued interest on cash deposits totaled $1,653 at year-end.

Book Value of Bonds **$1,708,401**

The above asset consists of the aggregate book value of bonds held by the company as of December 31, 2003. Bonds owned by the company are held under a safekeeping agreement with a bank.

Bonds were verified to applicable company investment custodial statement records, as documented in the independent CPA’s work papers. Bond purchases and sales for the period under examination were checked on a sample basis to brokers’ invoices and advices. The company's investment in bonds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Interest received during 2003 on bonds amounted to $86,543 and was traced to cash receipts records. Accrued interest of $20,134 at December 31, 2003, was checked and allowed as a nonledger asset.

Stocks and Mutual Fund Investments **$1,663,924**

The above asset consists of the aggregate market value of stocks and mutual funds held by the company as of December 31, 2003. Stocks owned by the company are located in a fireproof lockbox inside a vault.

Stock certificates were physically examined by the examiners. Stock and mutual fund purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in stocks and mutual funds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Dividends received during 2003 on stocks and mutual funds amounted to $32,497 and were traced to cash receipts records. The company did not have any accrued dividends at December 31, 2003.

Book Value of Real Estate **$69,011**

The above amount represents the company's investment in real estate as of December 31, 2003. The company's real estate holdings consisted of its home office building and land.

The required documents supporting the validity of this asset were reviewed and were in order. Adequate hazard insurance was carried on the real estate and contents as noted under the caption, "Fidelity Bond and Other Insurance." The company's investment in real estate and related items was in conformance with the Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers. Real estate depreciation is calculated using the straight-line method.

Premiums, Agents' Balances in Course of Collection **$11,712**

This asset represents the amounts due from agents or policyholders which are not in excess of 90 days past due at year-end. A review of individual agent's accounts verified the accuracy of this asset.

Premiums Deferred and Not Yet Due **$163,866**

This asset represents modal premium installments that are not yet due. The premium system used by the company does not provide detail reporting controls of deferred premium by policyholder. Accordingly, the deferred premium balance was verified by reconciling to the difference between system reporting controls of unearned premium based on original premium without endorsements, and unearned premium based on the most recent installment received. Unearned premium based on original premium was independently recalculated for all in-force register records, as further discussed under the caption “Unearned Premiums.” Unearned premium based on installments received was validated for the original cash receipts policy sample.

It was also noted that premiums received in 2003 for installments due in 2004 were reported as Advance Premiums. These premiums should have been reported as a reduction to deferred premium, therefore resulting in overstating this balance. The difference is below tolerable error and for that reason no adjustment will be made. Further discussion on this review will be discussed under the caption “Advance Premium.”

Investment Income Due and Accrued **$21,787**

Interest due and accrued on the various assets of the company at December 31, 2003, consists of the following:

Cash at Interest	$ 1,653
Bonds	20,134
Total	$21,787

The above interest due and accrued balances were reviewed on a sample basis for reasonableness.

Reinsurance Recoverable on Paid Losses **$11,877**

The above asset represents recoveries due to the company from reinsurance on losses which were paid on or prior to December 31, 2003. A review of year-end accountings with subsequent documentation verified the above asset.

Electronic Data Processing Equipment **$10,667**

The above balance consists of computer hardware and operating system software, net of depreciation as of December 31, 2003. A review of receipts and other documentation verified the balance. Non-operating system software was properly nonadmitted.

Fire Dues Recoverable **$132**

This asset represents the amount overpaid to the State of Wisconsin for 2003 fire dues. The examiners reviewed the company's fire department dues calculation and found this asset to be correctly calculated. The actual amount paid was verified to the cash disbursement records.

Health Insurance Recoverable **$3,022**

This asset represents a cancelled health insurance premium due to the company at December 31, 2003. Subsequent cash receipts were reviewed to verify the amount.

Cash Surrender Value of Life Insurance **$14,822**

This asset represents the cash value of life insurance policies the company has for two of its employees at December 31, 2003. Verification of this balance was made by obtaining confirmation documents from the life insurance company.

Furniture and Fixtures **$0**

This asset consists of $3,859 of office equipment owned by the company at December 31, 2003. In accordance with annual statement requirements, this amount has been reported as nonadmitted asset, thus the balance shown above is $0.

Prepaid Insurance **$0**

This $10,996 asset consists of the pro rata portion of insurance premiums that were unearned corporate insurance premiums as of December 31, 2003. In accordance with annual statement instructions and statutory accounting practices, this amount was reported as a nonadmitted asset.

Investment in Ascot Agency, Inc. $0

This $356 asset represents the result of the company's subsidiary operation as of December 31, 2003. The company has nonadmitted this asset.

LIABILITIES AND SURPLUS

Net Unpaid Losses **$87,937**

This liability represents losses incurred on or prior to December 31, 2003, that remained unpaid as of that date. The examiners reviewed the reasonableness of this liability by totaling actual loss payments made subsequent to December 31, 2003, with incurred dates in 2003 and prior years. To the actual paid loss figure was added an estimated amount for 2003 and prior losses remaining unpaid at the examination date. The examiners' development of unpaid losses is compared with the amount estimated by the company in the following schedule.

	Company Estimate	Examiners' Development	Difference
Incurred but unpaid losses	$165,197	$99,321	$65,876
Less: Reinsurance recoverable on unpaid losses	29,052	11,384	7,668
Net Unpaid Losses	$136,145	$87,937	$48,208

The majority of the difference between the examination loss reserve development and the reported loss reserve at year-end was due to the company's closing out of older claims in 2004. A sample of these claims were reviewed and noted that a majority of claimants had waived payments on settlement in order to obtain the three-year claims free discount on their premium. An adjustment was made to reduce this balance by $48,208 to what is currently reported. A corresponding entry was made to Surplus in the "Reconciliation of Policyholder's Surplus" section of this report.

The examiners' review of claim files included open claims, paid claims, claims closed without payment and all claims which were denied during the examination period. The review indicated that claims are investigated and evaluated properly and that payments are made in accordance with policy provisions upon the submission of a proper proof of loss. In addition, the review of claims handling procedures and files revealed the following:

1. A proper loss register is maintained.
2. Claim files contained sufficient investigatory data and documentation to verify settlement payments or reserve estimates.
3. Proofs of loss were properly signed.

Further review of the company loss expenses noted that the company included in its loss expenses the $10 fee paid to agents for reporting claims. These expenses should have been included as loss adjustment expenses since it relates to activities involved in inspecting claims and reimbursement for pictures and mileage. It is recommended that the company report Loss Adjustment Expenses in accordance with proper annual statement reporting.

Unpaid Loss Adjustment Expenses **$2,000**

This liability represents the company's estimate of amounts necessary to settle losses which were incurred prior to December 31, 2003, but which remained unpaid as of year-end. The company's current methodology for establishing this liability was found to inadequately estimate the company's loss adjustment expenses.

The examiners' used a paid loss adjustment expense to paid loss methodology to determine the expenses incurred by the company related to the settlement of losses for the past three years. The examiners weighted the more recent year's data to reflect current trends. Using that methodology, the estimated unpaid loss adjustment expenses were $6,757. The current difference was deemed to be below tolerable error and no audit adjustment was made. It is recommended that the company adopt an actuarial method, such as the paid to paid methodology, in order to determine a more adequate loss adjustment expense reserve.

Commissions Payable **$46,998**

This liability represents the commissions due to agents on premium which has been received in December 2003, plus commissions for billed deferred installments and billed renewal premiums, offset by commission receivable on ceded premiums. The company improperly included a liability for commissions on billed renewal premiums with 2004 effective dates not received by year-end 2003 in its calculation of commission payable. The current difference was deemed to be below tolerable error and no audit adjustment was made. It is recommended that the company only include commission payable on policies effective in the current year, and on advance premiums received, as commission payable.

In addition to the above recommendation, the company improperly netted reinsurance commission on ceded premium with agents' commission payable. Commission receivables on reinsurance ceded business should be included as an offset to Ceded Reinsurance Payable. It is recommended that the company net Commission Receivable on ceded premium against Ceded Reinsurance Payable in accordance with proper annual statement reporting. A reclassification entry was made increasing commissions payable by $4,261 and decreasing reinsurance payable by the same amount. The net result of the two adjustments to commission payable was a decrease of $5,624 to what is currently stated.

Unearned Premiums **$498,494**

This liability represents the unearned premiums, based on the annual premium, offset by ceded unearned premium based on installments. This reserve was established by a computer software program that uses a daily pro rata method based on 365 days. Policy data was tested and recalculated to verify the accuracy of this liability.

It was noted during the review of the unearned premium report that the annual premium included on the report deviated from the amounts stated on the policy declaration page. The discrepancy was because the unearned premium report obtained was generated on the new system and the policy declaration page was generated on the old system. The discrepancies between the two systems are that premium credits, such as claim-free discounts, are applied differently on each system. The company is currently reconciling each policy to the new system to ensure premium accuracy. The examiners are confident that the amounts of premiums reported by the company reasonably represent premium balances and discrepancies are below tolerable error. The discrepancies noted in the unearned premium report are due to the system conversion rather than to omissions or misstatements by the company personnel.

It was also noted during the review of unearned premium that the company had included in reinsurance payable the ceded deferred premium owed to its reinsurer, however the company did not reduce its unearned premium reserve for this amount, causing the company to overstate its liabilities. The reporting of the company's unearned premium liability is not in compliance with s. Ins 13.08 (3), Wis. Adm. Code. It is recommended that the unearned premium liability is properly reported to reflect the terms of the reinsurance contracts in accordance with

s. Ins 13.08 (3), Wis. Adm. Code. The amount is reduced by $28,406 with a corresponding entry made to surplus in the "Reconciliation of Policyholder's Surplus" section of this report.

Reinsurance Payable **$3,292**

This liability consists of amounts due to the company's reinsurer at December 31, 2003, relating to transactions which occurred on or prior to that date. The amount stated on the annual statement pertains to the company's ceded deferred premium amount for Class B offset by the amount overpaid to the company's reinsurer for Class A, Class C and Class D/E coverage. The examiners reviewed the company's adjusted premium calculation and found this liability to be correctly calculated; however, the company improperly netted reinsurance commission on ceded premium with agents' commission payable rather than netting it against Ceded Reinsurance Payable. For further review on this exception, refer to the "Commissions Payable" section of this report. A reclassification entry was made by decreasing reinsurance payable by $4,261 to what is currently reported and increasing commission payable by the same amount.

The subsequent amount paid for Class B was verified to the cash disbursement records and the actual amount received for the overpaid ceded premium was verified to the cash receipt records.

Amounts Withheld for the Account of Others **$3,352**

This liability represents employee payroll deductions in the possession of the company at December 31, 2003. Supporting records and subsequent cash disbursements verified this item.

Payroll Taxes Payable **$882**

This liability represents the company's portion of payroll taxes incurred prior to December 31, 2003, which had not yet been paid. Supporting records and subsequent cash disbursements verified this item.

Accounts Payable **$2,404**

This liability represents an accrual for general expenses incurred prior to December 31, 2003, which had not yet been paid. Supporting records and subsequent cash disbursements verified this item.

Directors' and Agents' Fees and Expenses Payable **$2,861**

This liability represents amounts due to directors for meeting attendance and travel allowance, during the fourth quarter of 2003. Supporting records and subsequent cash disbursements verified the balance.

Accrued Deferred Compensation **$15,813**

This amount represents the deferred compensation liability for two of the company's employees as of December 31, 2003, pursuant to the board's salary continuation plan. The calculation is based on an 8.5% rate of interest and appears reasonable.

Premiums Received in Advance **$28,056**

The examiners' review of the items reported as advance premiums found that this amount represents the total premiums received prior to year end for policies with effective dates in 2004, as well as premium received for installments due January 2004. By including the premium received for deferred installments, the company has overstated this liability. Premiums received in 2003 for installments due in 2004 should be reported as reductions to Premiums deferred and not yet due. The difference is below tolerable error and therefore no adjustment was made. It is recommended that the company properly record advance premiums in accordance with the Town Mutual Annual Statement Instructions.

VI. CONCLUSION

The company reported total admitted assets of $3,995,179, total liabilities of $768,702 and surplus of $3,226,447 at December 31, 2003. There was one reclassification and two adjustments to surplus as a result of this examination. The examination determined that as of December 31, 2003, the company had total admitted assets of $3,995,179, total liabilities of $692,088 and surplus of $3,303,091.

The examination resulted in seven recommendations and one suggestion. The recommendations relate to the company's agents' agreement, commission payable, loss expense, unpaid loss adjusting expenses, unearned premium and advance premium. The suggestion relates to the accounting system conversion.

As indicated in the "Growth of the Company" section of this report, the company has been experiencing a decline in policies in force over the past five years, which averages around 2% a year. The decline can be contributed to rate increases, competition and tightened underwriting standards. Although policyholder counts have declined, the company continues to have strong surplus with slightly above average loss and expense ratios.

Though there were several discrepancies noted with the company's premium reports during the examination, the company was able to reconcile most of the discrepancies before the examination began. The company personnel's knowledge of the premium reporting systems and their ability to resolve the complex discrepancies was very impressive, and the examination compliments the company for its attentiveness and good record keeping.

VII. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 18 - Agent's Agreement—It is recommended that the company execute formal written agreements with its agents that include language indicating that the agent will represent the company's interests "in good faith."

2. Page 20 - Accounts and Records—It is suggested that the company work with its software vendor to fix the problems noted with the accounting system so that premium balances are reported accurately.

3. Page 29 - Loss Expenses—It is recommended that the company report Loss Adjustment Expenses in accordance with proper annual statement reporting.

4. Page 29 - Unpaid Losses Adjustment Expenses—It is recommended that the company adopt an actuarial method, such as the paid to paid methodology, in order to determine a more adequate loss adjustment expense reserve.

5. Page 29 - Commission Payable—It is recommended that the company only include commission payable on policies effective in the current year, and on advance premiums received, as commission payable.

6. Page 30 - Commission Payable—It is recommended that the company net Commission Receivable on ceded premium against Ceded Reinsurance Payable in accordance with proper annual statement reporting.

7. Page 30 - Unearned Premium—It is recommended that the unearned premium liability is properly reported to reflect the terms of the reinsurance contracts in accordance with s. Ins 13.08 (3), Wis. Adm. Code.

8. Page 32 - Advance Premium—It is recommended that the company properly record advance premiums in accordance with the Town Mutual Annual Statement Instruction.

VIII. ACKNOWLEDGMENT

The courteous cooperation extended to the examiners by the company's personnel is hereby acknowledged.

In addition to the undersigned, Elena Vetrina of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Respectfully submitted,

Sheur Yang
Examiner-in-Charge

IX. SUBSEQUENT EVENT

On August 24, 2004, the boards of directors of the company and of Union Mutual Fire Insurance Company (Union) approved a plan of merger. A joint membership meeting of Union and Sugar Creek was held on November 22, 2004, where members for both companies voted in favor of the merger. The merger is to be effective January 1, 2005, with Union merging into the company. Business will be transacted from the company's homeoffice in Elkhorn and all accounts of Union will be owned by the company, including property owned by Union. The members and policyholders of Union will automatically become members and policyholders of the company. In conjunction with the merger, two officers of the Union will join the board of directors and the Articles of Incorporation and Bylaws of the company will be amended to clarify the duties and responsibilities of the officers.

The merger has been approved by this Office.